tsg
# TAX PERSPECTIVES
A QUARTERLY PUBLICATION OF THE TAX SPECIALIST GROUP (TSG)

## Introduction

Michael Cadesky FCA, FTIHK, TEP
Cadesky and Associates

This is the first issue of the Tax Specialist Group's quarterly newsletter. We hope you enjoy the broad range of tax-related articles. More detailed information is often available on our Web site at **www.taxspecialistgroup.ca**.

Tax Specialist Group, TSG, is a collaboration of like-minded tax specialist firms. Each member firm of chartered accountants focuses on tax consulting and related services. The founding members are Bateman MacKay, Cadesky and Associates, and Moody Finningley Shikaze.

### BATEMAN MACKAY

Bateman MacKay, Burlington, focuses on scientific research tax credit work, providing services to Canadian businesses of all sizes.

### CADESKY AND ASSOCIATES

Cadesky and Associates, Toronto, is a tax consulting firm with a broad focus on Canadian and international tax matters. Its partners and principals include chartered accountants, tax lawyers, and business valuators.

### MOODY FINNINGLEY SHIKAZE

Moody Finningley Shikaze, Calgary, a tax consulting practice, focuses on Canadian tax matters and especially estate planning.

The collaboration of these firms allows for greater specialization. Together, the group has over 20 senior professionals engaged in tax consulting and related services.

## Changes to capital gains: Some implications

Gary L. Bateman P ENG, MBA, CA
Bateman MacKay

Fundamental changes to capital gains taxation have far-reaching implications. Some old rules of thumb and established practices need to be rethought.

As readers may be aware, the inclusion rate for the taxation of capital gains fell over the course of 2000 from 75 to $66\frac{2}{3}$ to 50%. In the space of a single year, the federal government rolled back all the capital gains tax increases since 1988. There is even some talk by political leaders of eliminating the tax altogether. The table below outlines the history of capital gains taxation in Canada.

These changes warrant a review of strategies for holding investment assets. (Note that farm assets and shares of Canadian-controlled private corporations that meet certain conditions are eligible for a $500,000 lifetime

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# Update on stock option benefits

Kim G.C. Moody CA, TEP

Moody Finningley Shikaze

With this draft legislation, the federal government clearly intends to put Canadian employees of publicly traded corporations on an equal footing with employees in other countries that, until now, have offered more favourable tax treatment than Canada.

Changes to stock option benefits were announced in the February 2000 federal budget. The rules are complex, and can backfire on the unwary. Whether they are beneficial depends on how well you play the rules.

Draft legislation implementing the proposals to modify the taxation of stock option benefits has now been released. Previously, if an employee of a publicly traded corporation exercised a stock option, the fair market value (FMV) of the underlying security less the "strike price" was included as a taxable benefit. This was included in the employee's income in the year of exercise, whether or not the security was sold. This often posed problems for employees who could not or did not wish to sell the underlying security. They were often forced to exercise the options and then sell the underlying security to pay the tax on the taxable benefit.

Now, under the draft legislation, where an employee exercises options and holds on to the underlying security, the taxable benefit on the first $100,000 of "specified value" may be deferred. (The specified value is the value of the security at the time the option is granted.)

A number of new planning opportunities are now available. This article highlights the proposals and identifies the opportunities for employees of publicly traded corporations.

## HIGHLIGHTS AND OPPORTUNITIES

1. To use the $100,000 annual deferral, an election must be filed no later than January 15 of the following year. For 2000, there is no deadline until the draft legislation receives royal assent.
2. "Specified value" is computed with respect to an option's "vesting year." No more than $100,000 of specified value can be used for each year that an option vests. This can provide planning opportunities when setting up stock option plans: to maximize the deferral, at least $100,000 of specified value can be established for each employee for each vesting year.
3. Where an employee files an election to defer the eligible stock option benefit, the employer is not required to withhold income tax on the otherwise taxable benefit.
4. An employee must report the amount of the deferral and related details in prescribed form for every year the deferral is taken.
5. The cost of underlying securities acquired via the exercise of stock options where the benefit is deferred is calculated separately from the normal "pooling" calculation. This can provide planning opportunities when determining when and how to dispose of such securities.
6. The draft legislation includes new rules with respect to securities that are acquired via the exercise of stock options and disposed of within a 30-day period.
7. There are new planning opportunities where options with a number of different vesting years are acquired. Ordering rules in the draft legislation will help in deciding the order in which to dispose of securities so as to maximize the deferral.
8. In certain circumstances, an employee can revoke an election to defer the benefit, which may assist in

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# Tax shelter litigation update

A. Christina Tari BA (HON.), LLB, LLM, TEP

Richler and Tari, Tax Lawyers

Beginning in 1987, the Auditor General and various committees reviewing Canada's fiscal policies criticized Revenue Canada for being too lax with respect to "tax avoidance." In response, Revenue Canada (now the CCRA) increased its contingent of tax-avoidance officers and developed national projects aimed at deterring perceived tax avoidance strategies, many of which involved tax shelters.

To withstand the CCRA's onslaught against tax shelters, the only way is to band together in a group. Against seemingly endless resources and delays, individual taxpayers don't really stand a chance. Here is an update on what has been going on.

### COMPUTER SOFTWARE SHELTERS

The CCRA has assessed virtually every computer software shelter it has been able to identify, beginning with the 1993 taxation year. The grounds on which the CCRA has reassessed are numerous; tax auditors have a "global" list of grounds from which to choose. We have successfully negotiated away some of these issues in certain files.

However, the CCRA now seems to be at a standstill in terms of any meaningful settlement. A decision of Judge Rip of the Tax Court of Canada in *Peter Brown v. The Queen* is pending, and the CCRA believes that the decision will set a precedent. Almost all of the CCRA's potential assessing positions on the global list were assumed by the auditor in the case. These were all argued at trial.

In *Brown*, a (general) partnership acquired 11 computer software programs that were to be used to develop computer games. Revenues from the sale of the games were to be pooled so that if one game succeeded, the partners would

Tax shelter litigation update, page 8

To withstand the CCRA's onslaught against tax shelters, the only way is to band together in a group. Against seemingly endless resources and delays, individual taxpayers don't really stand a chance.

MEMBER PROFILE

## Gary L. Bateman P ENG, MBA, CA

One of Canada's foremost authorities on R & D tax incentives

Gary Bateman, founder and senior partner of Bateman MacKay, Chartered Accountants, combines his engineering background with his accounting and tax skills to produce a valued client service. Understanding technology, accounting, and tax gives Gary a unique perspective on assisting clients in obtaining R & D tax credits.

Gary is one of Canada's foremost authorities on R & D tax incentives, having authored the *Guide to the Taxation of R & D Expenses*, a loose-leaf professional reporting service published by Carswell. He is also author of the popular paperback *A Declaration of Taxpayer Rights*.

With his extensive teaching experience, Gary has trained his professional staff of eight on the intricacies of R & D tax credits. The group consults to over 200 clients across Canada on how to maximize federal and provincial R & D tax incentives.

A detailed description of Gary's R & D services can be found on our Web site.

# E-commerce within an international environment: Part I

Grace Chow CA, FCCA, ATIHK, TEP

Cadesky and Associates

New technology brings new ways of conducting business. The Internet offers these methods to companies of all sizes, and makes it possible to set up shop outside Canada and save large amounts of tax. Since national boundaries are nonexistent in the world of e-commerce, which countries have the right to tax what income? This article provides an overview of the issues to consider when structuring an e-commerce-based business in an international environment.

## TYPICAL SCENARIO

Assume that a Canadian-resident corporation (Canco) sells to customers worldwide (including Canada). Sales are made through a Web site located outside Canada that is owned and operated by a non-resident corporation (Websiteco), a wholly owned subsidiary of Canco. Customers order through the site and Websiteco arranges with Canadian arm's-length suppliers to ship goods to customers. (See the accompanying illustration.)

We consider two scenarios using these assumptions. In the first, Websiteco is located in a tax haven that imposes little or no tax. In the second, Websiteco is located in a country with which Canada has a tax treaty.

## TAX HAVEN LOCATION

Tax haven countries typically do not have tax treaties with Canada or other G7 countries. If Websiteco is located in a tax haven, from a Canadian tax perspective the key question is whether Websiteco earns income from a business carried on in Canada. If it does, the income is taxable in Canada. If it does not, there will be no tax payable in Canada.

### Carrying on business in Canada

Under the Canadian Income Tax Act, a non-resident person (such as Websiteco) who "*solicits orders* or *offers anything for sale* in Canada *through an agent or servant*, whether the contract or transaction is to be completed inside or outside Canada," is deemed to be "carrying on business in Canada."

Is Websiteco "soliciting orders"? According to Canadian case law, orders are solicited only if they are sought and attempts are made to obtain them within the jurisdiction—in this case, Canada. "Offers" has its ordinary meaning in contract law; that is, a contract is created as soon as the offeree accepts the offer. If a Web site merely provides information to invite people to learn more about a prod-

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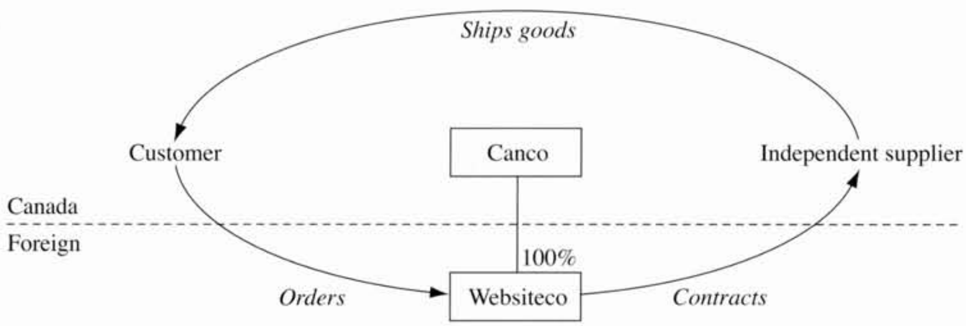
If a Web site merely provides information to invite people to learn more about a product, it seems that orders are not being solicited and goods are not being offered for sale. However, if customers can place orders through the site, it is likely that orders are being solicited.



# In brief

## NEWS OF IMPORTANT TAX DEVELOPMENTS

Howard Berglas

Cadesky and Associates

A recent court decision and two tax rulings illustrate that some perks received by employees from their employers may not be taxable, even if they contain a personal element.

## Surviving the kiddie tax

Effective after 1999, the so-called kiddie tax applies to minor beneficiaries of inter vivos trusts that earn dividends from private corporations. It also applies to business income earned by management partnerships that provide administrative and other support services to related businesses.

Close analysis of the rules can suggest creative ways to still split income among family members and reduce the overall tax liability while avoiding the kiddie tax:

- "Split income" subject to the kiddie tax does not include capital gains or interest income. Dividends can be converted to capital gains by various means, and built-up capital can be loaned to operating corporations at reasonable rates of interest.
- Income from a partnership can be distributed to nieces and nephews of the persons carrying on the partnership business.
- Income generated by trusts or by limited partnerships with trusts as their partners, that provide services directly to arm's-length persons, should not be subject to the rules.
- Spouses and children over 18 are not caught by the rules.
- Dividends from public companies are excluded.
- Split income is not subject to federal or provincial surtaxes.

Taxpayers with family trusts should also consider other income-splitting or deferral strategies such as RESPs, reasonable salaries to minors for work performed, and gifts to adult children.

## Partnerships and statute-barred periods

Partnerships with five or fewer partners are not required to file partnership information returns. However, if a return is not filed, the partners' tax returns may be reassessed even after the normal statute-barred period (usually three years following assessment) with respect to their partnership income or loss. In light of this rule, it may always be advisable to file a partnership return.

## Clergy get clobbered

Recent court decisions have expanded the number of persons who meet the definition of clergy, enabling them to claim a deduction in respect of their residence. In response to the decisions, the Department of Finance has made legislative changes to limit the deduction commencing in the 2001 taxation year. The deduction will be limited to the least of

1. the clergyman's remuneration from the office or employment;
2. one-third of the remuneration or \$10,000, whichever is greater; and
3. the fair rental value of the residence.

In the past, the clergy deduction was limited only by the first and third amounts. It seems that when it comes to the Department of Finance, nothing is sacred.

## Tax-free perks?

A recent court decision and two tax rulings illustrate that some perks received by employees from their employers may not be taxable, even if they contain a personal element.

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SERVICE PROFILE

# Estate planning

Appropriate and timely estate planning is critical to maximizing long-term family wealth. Too often the pressures of modern life leave little time and energy for personal planning. This planning gets neglected, postponed, or pushed aside until it is too late.

We are very experienced in designing, implementing, and monitoring estate plans. When entrusted with such a project, we

- prepare a summary of the client's major assets and liabilities, and evaluate the tax consequences involved in passing these assets to the next generation;
- review the client's will and determine the family's personal wishes with respect to the succession of assets;
- determine whether there is a need for insurance and the type of insurance, and suggest an amount;
- develop an estate plan, which may involve an estate freeze or a gifting program;
- coordinate the implementation of the estate plan;
- recommend revisions to wills to enhance the effectiveness of the tax planning and lighten the tax burden on the estate and heirs; and
- recommend an approach to investment, and introduce investment advisers if required.

Often a plan can be designed to pass on a family business to children on a tax-free basis. However, this takes many years to fully implement, so it is important to start the process early.

We monitor estate plans year by year to make sure everything is on track. We often adjust a plan for changing financial circumstances; changing family, financial, and personal objectives; and changing tax laws. We also give periodic updates on how the plan is evolving and whether it is meeting its objectives.

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### Parking

The court in *Chow et al.* decided that employees were not required to include in taxable income the value of free parking spaces provided to them. The court found unfair the Crown's presumption that employer-provided parking is by its nature a taxable benefit; each case must be looked at on its facts to determine whether an economic benefit accrued to the employee as opposed to the employer. Where it can be shown that the economic benefit arose in favour of the employer, as it did in *Chow*, a taxable benefit should not arise. For example, if an employer provides free parking to improve employee performance or to save on taxi fares, the courts may see the "perk" as being primarily for business purposes that benefit the employer, and thus not taxable to the employee.

### Tuition fees, computers

In two recent tax rulings involving tuition fees and computer costs, the CCRA acknowledged that no benefits would arise in the hands of employees.

In the case of tuition fees paid by an employer, the CCRA ruled that "fees and other associated costs such as meals, travel, and accommodations, which are paid for courses leading to a degree, diploma or certificate in a field related to the employee's current or potential future responsibilities in the employer's business," will not result in a taxable benefit to the employee.

In the case of computer costs, the CCRA stated that no taxable benefit would arise on an arrangement to share the cost of computers whereby the employer leases computers and the employees have the option of buying the computers from the lessor at the residual value. Participation in the program must be voluntary. In the CCRA's view, as long as the employees are not behind the initiative of acquiring the computers and the employer benefits because the employees, as a result, are better trained and informed, no taxable benefit would arise.

*Chow et al.* and the rulings leave open the door for the creation of very interesting incentive programs that may not give rise to taxable benefits.

## New thin cap rules

Rules limit or prohibit the deduction by corporations of interest on debt paid to certain specified non-residents. Prior to recent amendments, an interest deduction was disallowed where the corporation's debt-to-equity ratio in relation to specified non-residents exceeded 3:1.

Draft legislation introduces the following changes for taxation years beginning after 2000:

1. The relevant debt-to-equity ratio is 2:1.
2. The method of calculating the debt and equity in the ratio is modified based on monthly averages.

Corporations that pay interest to specified non-resident shareholders should review their debt-to-equity ratios in light of these rules to ensure that their interest deductions are not restricted.

The changes to the calculation of the ratio will significantly alter the manner in which Canadian subsidiaries are capitalized by their multinational parent corporation. Fortunately, the proposal to restrict interest on debt to non-specified arm's-length lenders, where the debt has been guaranteed by a specified non-resident shareholder, has been scrapped.

## Capital gains continued from page 1

capital gains exemption and are not discussed here.) In this article we consider two of the most common strategies: investing through RRSPs and estate freezes.

| Date | Income inclusion |
|---|---|
| 1917 to December 31, 1971 | 0% |
| January 1, 1972 to December 31, 1987 | 50% |
| January 1, 1988 to December 31, 1989 | 66 2/3% |
| January 1, 1990 to February 27, 2000 | 75% |
| February 28 to October 17, 2000 | 66 2/3% |
| October 18, 2000 to date | 50% |
| The future? | 0% |

The table below provides the context for this review. It shows the tax rates for different types of income, across all provinces at the top marginal rate, which for 2001 is over $100,000. Capital gains in 2001 are taxed at half the rate at which interest income is taxed for all tax brackets and in all provinces.

### RRSPs

RRSP investment strategies need to be rethought. Many Canadians have the majority of their investment capital in RRSPs, and use these vehicles for interest-bearing, dividend-paying, and appreciating investments. The effect of a capital gains inclusion rate reduction is important to consider.

RRSPs are valuable for their tax-free compounding of investment income. But if the rate of return on an asset is predominantly capital appreciation, tax will arise only when the asset is sold. Using RRSPs to defer the tax on capital gains investments is a strategy that should be approached now with caution. Capital gains on the sale of RRSP assets may be taxed at the top rate when the funds are ultimately withdrawn.

For example, a bank stock, based on average performance over the last 40 years, doubles every 7 years and pays a dividend of about 3%. If an initial investment of $10,000 were held 21 years within an RRSP, it would grow to $80,000. On withdrawal, the entire $80,000 would be taxable, at a rate of about 46% (in Ontario). Tax of $36,800 would be due, leaving net proceeds of $43,200. However, if the same investment were held outside an RRSP, the tax due on sale in 21 years would be $16,100, leaving $63,900 after tax. In order for the tax-free compounding of the dividend income to com-

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| | YK | NU/NWT | BC | AB | SK | MB | ON | QC | NB | PEI/NS | NF | Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2000** | | | | | | | | | | | | |
| Interest income | 45.4 | 43.5 | 51.3 | 43.7 | 48.2 | 48.0 | 47.9 | 55.4 | 49.2 | 48.8 | 51.3 | 48.43 |
| Capital gains* | 34.0 | 32.6 | 38.5 | 32.8 | 36.1 | 36.0 | 35.9 | 41.6 | 36.9 | 36.6 | 38.5 | 36.32 |
| **2001** | | | | | | | | | | | | |
| Dividend | 29.0 | 28.4 | 36.0 | 24.7 | 29.6 | 34.0 | 31.3 | 36.8 | 31.4 | 32.0 | 32.9 | 31.46 |
| Capital gains | 21.5 | 21.0 | 24.3 | 19.7 | 22.5 | 23.2 | 23.2 | 24.6 | 23.4 | 23.7 | 24.3 | 22.85 |
| Interest income | 43.0 | 42.0 | 48.7 | 39.5 | 45.0 | 46.5 | 46.4 | 49.3 | 46.8 | 47.4 | 48.6 | 45.75 |

** Calculated at 75% rate.*

# Capital gains continued from page 7

pensate for the doubling of the tax on the capital appreciation, the hold period of an investment has to be 50 years! Of course, this assumes that the share investment will be retained for 21 years. Otherwise, the tax deferral on reinvestment of the capital gain would have to be considered.

This strategy change goes right to the heart of the value of the RRSP. We advise that the use of RRSPs for capital gains investments should be reserved for trading accounts (which would otherwise be on income account) and the fixed-income portion of an investment strategy. Long-term stock holders should resist the quick fix of the RRSP deduction and hold these assets outside an RRSP for substantial advantage.

### ESTATE FREEZES

Taxpayers often want to freeze future growth in their estate, to ensure that the growth is earned by the next generation. This is commonly done by converting the current value of the estate into fixed value preferred shares of a holding company and then redeeming those shares over time. This converts the capital gains tax, currently calculated but not due, into a future stream of dividends with immediate taxability on each redemption.

Although this strategy used to save tax, as the figures in the table show, it will now increase the tax on assets by a substantial margin and move the taxation up from "later" to annual hits.

Consider that the tax rate on dividends is around 31% (in Ontario). Last year, capital gains were taxed at about 36%. Now they are taxed at 23%. This is a dramatic change.

Readers who wish to review their financial strategies in light of the changes in the taxation of capital gains should contact one of our member firms for expert assistance and advice.

# Stock option benefits continued from page 2

planning opportunities where other deferral decisions should or could have been made.

9. The deferral ends when an employee sells the underlying security, or if the employee dies or becomes a non-resident of Canada.

Unfortunately, the new rules do nothing to address one of the most serious drawbacks to stock options. If the stock declines in value after exercise, the result may be a capital loss. This capital loss cannot offset the employment benefit. In extreme cases, this can lead to financial hardship, where the tax on the employment benefit exceeds the value of the shares (after a severe market decline). Exercising options and holding shares can be a dangerous financial strategy, especially with a volatile stock.

### CONCLUSION

With this draft legislation, the federal government clearly intends to put Canadian employees of publicly traded corporations on an equal footing with employees in other countries that, until now, have offered more favourable tax treatment than Canada.

The tax specialists of TSG would be happy to provide further information and assistance with respect to stock options. TSG is also preparing a stock option booklet that will be available later this year.

# Tax shelter litigation update continued from page 3

share in the bonanza and could offset the losses from the unsuccessful games.

The CCRA assessed the limited partners in the shelter in *Brown* on the basis that the partners bought the partnership units as a tax shelter in order to obtain tax savings and not to earn income from a business or property, and that the partnership was set up solely to enable the partners to obtain tax savings. Further, the CCRA stated that the partnership acquired the software at an inflated cost from a non-arm's-length party. The Crown argued (1) that the partners had no reasonable expectation of profit and (2) that the sales agreement contained a clause "guaranteeing" the partners sufficient income to cover their liability on the promissory notes.

Therefore, the Crown argued, the partners' liability was at best "contingent" and should not form part of the cost base for the computer programs. The Crown further argued that (3) the partners had no amount "at risk" and the Income Tax Act requires that a taxpayer have an amount "at risk"; (4) the partnership and the developer of the programs were not dealing at arm's length; (5) the purchase price of the computer programs was not "reasonable"; (6) the FMV of the computer programs was far less than the appraised value obtained by the partnership; and (7) the computer programs were not "available for use" in the taxation year because they were not ready for sale.

We believe that the sensible settlement of all software shelter cases is at an impasse until the decision in *Brown* is released. We have been waiting over a year for Judge Rip to release his judgment and reasons. Unfortunately, it is also a given that whoever loses in the Tax Court will almost certainly appeal to the Federal Court of Appeal, and the appeal will take another two years.

There is no question that investors in computer software shelters will be reassessed, if that has not already occurred, so be prepared.

## ART DEALS

The CCRA's national reassessment project with respect to charitable donations of art was initially trumpeted as an attempt to shut down the "mills" in which art was allegedly created only after promoters had gathered investment dollars. The CCRA then proceeded to assess and to disallow most such deductions claimed in 1996 and subsequent taxation years.

The reassessment process begins with a questionnaire. These questionnaires of varying length are sent to investors who claimed sizable charitable donations. The questionnaires have a standard form, as do the proposal letters that seem to be issued to taxpayers regardless of their responses on the questionnaires.

The letters and reassessments for the 1996 taxation year alleged that the taxpayers had not made a gift, and then assessed on alternative bases, including allegations that the art was not personal-use property and that its value was the cost at which the taxpayer acquired it. One of the most contentious assessing positions is the levying of a gross negligence penalty on the basis that the taxpayer ought to have known that the value of the art was too high.

We have instituted court action to take issue both with the substance of these claims and with the CCRA's attempt to raise alternative bases for assessment, which appear to be an abusive exercise of ministerial duty. We have also developed responses to the questionnaires and pleadings to address our concern with the minister's assessing positions, both substantive and procedural.

Note that the minister's position appears to be changing with respect to 1997 and later taxation years for "art deals" as a result of the Federal Court of Appeal's determination in *Duguay v. The Queen* that there is certainly a gift in such charitable donation situations.

## FILM SHELTERS

Once considered the "sacred cow" of Canadian tax shelters and Canadian cultural policy, film shelters are now being attacked by the CCRA on the basis that there is no reasonable expectation of profit in the investment. The fact that rulings were obtained from the CCRA in relation to film shelters provides little comfort. Careful study of these rulings shows that they offer no opinion on the issue of whether a reasonable expectation of profit existed.

Once considered the "sacred cow" of Canadian tax shelters and Canadian cultural policy, film shelters are now being attacked by the CCRA on the basis that there is no reasonable expectation of profit in the investment.

Certain investors in the Sentinel Hill group recently received questionnaires. If past CCRA practice with respect to tax shelters is any guide, proposal letters and reassessments are not far behind.

Where the CCRA assesses a shelter involving more than one investor, we advise group representation by a tax professional with experience in negotiating and litigating tax shelter cases. Group representation offers investors economies of scale that individual representation does not—an important consideration given the Crown's seemingly bottomless pockets.

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*A. Christina Tari is a founder of Richler and Tari, Tax Lawyers, who restricts her practice to tax litigation. Christina often works closely with members of the Tax Specialist Group. She can be reached at Richler and Tari, phone 416-498-9500, fax 416-498-9501.*

# Documenting R & D claims

Gary L. Bateman P ENG, MBA, CA

Bateman MacKay

Like most assets of a corporation, SR & ED claims need to be reviewed periodically in order to optimize the return—the reduction in tax—on the investment. In our experience, even persons who are long-time claimants can benefit from a review of the claim's method of assembly and documentation.

People will spend countless hours doc-umenting an expense report to claim a $12 taxi ride or a meal. Yet when it comes to documenting SR & ED claims, which can yield astonishing tax refunds, people have a whole array of excuses. Many believe that their companies are not really doing R & D, while others feel it is too much trouble or do not want to submit to an audit.

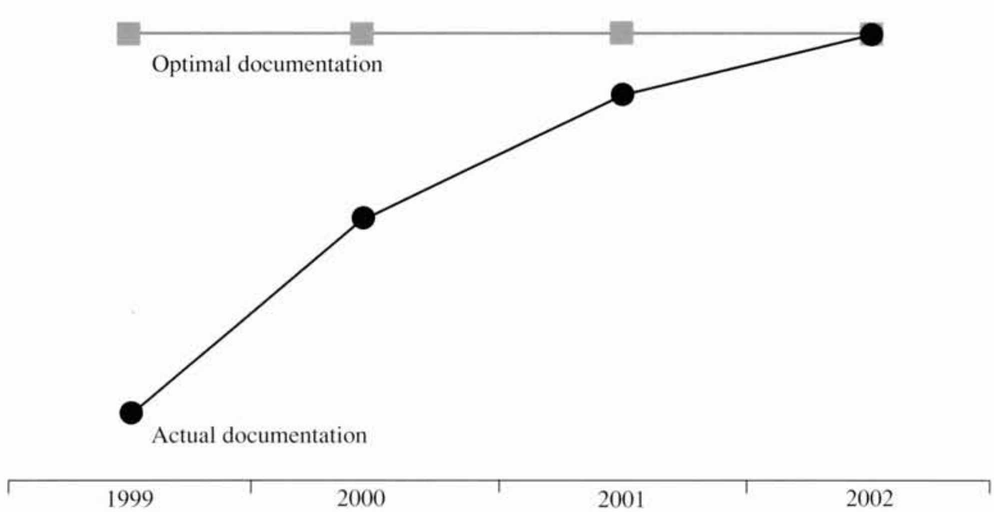
Properly documented SR & ED claims receive a federal tax credit of 20 or 35% and qualify for incentives in most provinces as well. Like most assets of a corporation, SR & ED claims need to be reviewed periodically in order to optimize the return—the reduction in tax—on the investment. In our experience, even persons who are long-time claimants can benefit from a review of the claim's method of assembly and documentation. This article describes SR & ED documentation requirements and suggests some strategies for maximizing the value of claims.

## REQUIREMENTS

The most important part of a successful SR & ED claim is a description of R & D activities. These activities are the "building blocks" of an R & D project and are crucial to the overall success of a claim. All costs are documented at the activity level and grouped into projects for filing as a finalized claim. The description in the claim must show that:

1. the R & D activities have a goal of technological advancement that will be a departure from the corporate standard practice;
2. technological uncertainty must be present and efforts to remove it must be made through the research of alternatives; and
3. research was performed and documented on these alternatives, and documents to prove this research are retained.

Keeping track of false starts and failures, and recording new knowledge of



uncertain value, gained from such failures, may go against the business grain and not be common in R & D departments. But good SR & ED tax documentation requires such detail. The downloadable form on our Web site (www. bateman-mackay.com) can assist in creating, reviewing, and managing this documentation.

### GETTING UP TO SPEED

New SR & ED filers and those who have not reviewed their R & D performance for a number of years face the challenge of documenting their R & D activities well enough to make a successful claim. Time is an important factor here, given the deadlines for making a claim and the fallibility of memory.

Assume that a new filer has a December 31 year-end. Also assume that its level of qualifying R & D activity is constant from year to year. It can make an SR & ED claim for fiscal 2000 by filing the claim by June 30, 2001, and it can change or make its fiscal 1999 claim by filing an amendment by the same date. A review now of R & D activities for 1999 will likely show an incomplete picture of what actually happened. A review of activities for 2000, while it may also yield incomplete results, will very likely be much more complete than the 1999 review. With a reviewing process in place as of 2001, the review of activities for 2001 and later years will approach the optimal level of SR & ED documentation accuracy. The accompanying figure shows the learning curve involved in getting up to optimal documentation speed.

There are several reasons for this learning curve, all of them related to the memories of the researchers involved in the R & D. Since claims are mostly labour, correct documentation of the labour component will improve the overall claim.

First, people's memories of recent activities are better—more accurate and complete—than their memories of activities long past. A review of activities a year old will thus produce better documentation than a review of activities two years old.

Second, people tend not to remember all of the activities in an R & D project. The omission of past activity costs is why current-year expenditures often exceed past-year costs, even if the level of activity has not changed from year to year.

Third, researchers often document only the time they spend on R & D and omit the rest of the day, thereby artificially "controlling" R & D time by reducing it. In our experience, this effect can reduce a claim by as much as 15%.

### RECOMMENDATIONS

1. Have a specialist in the area review the R & D claim at least once every three years. Annual reviews are best, to keep the learning curve from costing more than it should.
2. Implement a time record system that records whole days and encourages researchers to allocate their time for the whole day, over all their activities.
3. Review R & D activities quarterly so as to keep track of essential activities that might otherwise fail to be documented.

We would be pleased to help any readers review and assist in optimizing their R & D tax filings.

## E-commerce continued from page 4

uct, it seems that orders are not being solicited and goods are not being offered for sale. However, if customers can place orders through the site, it is likely that orders are being solicited.

If the customer is in Canada, orders are presumably being solicited by the Web site activities in Canada. Even if Websiteco approves the orders offshore, it may still be deemed to be soliciting orders in Canada, because the location where the contract or transaction is completed is not the determining factor. Thus it is likely that Websiteco would be deemed to be soliciting orders for sale in Canada.

### Agent or servant

Next, we need to ask whether orders are being solicited "through an agent or servant" in Canada. The issue of whether a Web site can be an agent or a servant has been studied by the OECD. In its view, if a Web site is hosted by an Internet service provider (ISP), the ISP will be considered an independent agent acting in the ordinary course of its business. The OECD has also commented that since a Web site is not a person, it cannot be an agent. Thus, if the only connection between Websiteco and Canada is the Web site, which is accessible by Ca-

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nadian customers through an ISP, it seems safe to conclude that Websiteco does not carry on business in Canada. If Websiteco does not carry on business in Canada, its income will not be taxable by Canada.

### Treaty country location

If Websiteco is to have operational connections with Canada or if it wishes to use Canco's services extensively, it should consider locating in a country with which Canada has a tax treaty. Otherwise, these connections could render it taxable by Canada. A treaty will override Canadian domestic law, making business income far less likely to be taxed in Canada. Unfortunately, the tradeoff is that treaty countries have higher tax rates than tax havens.

A treaty will override Canadian domestic law, making business income far less likely to be taxed in Canada. Unfortunately, the tradeoff is that treaty countries have higher tax rates than tax havens.

If Websiteco is located in a treaty country, its business profits are taxable only in the country where it is resident—unless it carries on business in Canada through a *permanent establishment*. If Websiteco has no permanent establishment in Canada, it will not be taxable.

"Permanent establishment" is generally defined in treaties as a *fixed place of business*, such as an office, branch, factory, or warehouse. This definition predates the advent of ISPs and Web sites. However, the OECD has suggested that a Web site is not considered a permanent establishment as that term is used in the OECD model tax convention.

### Fixed place of business

Although a Web site itself is not a permanent establishment, other factors need to be considered as well.

If Websiteco operates its own server, then in the OECD's view the server on which a Web site is operated is a piece of equipment with a physical location, and may thus be considered a fixed place of business. If the Web site is operated by an ISP, then although it may constitute a fixed place of business, it is not a fixed place of business of Websiteco. Rather, it is a fixed place of business of the ISP. Thus, having the Web site hosted in Canada by an ISP should not, in itself, lead to a Canadian permanent establishment.

The debate over e-commerce and permanent establishments is still going strong. Another OECD task force is considering whether the definition of permanent establishment should be amended to account for e-commerce. If the definition is updated, tax treaties around the world will no doubt be modified as well, but before this occurs there will be many years of tax-planning opportunities.

Readers who are considering extending their business through Web site activity should seek professional advice on doing so in a tax-effective way.

### STAY TUNED

The next issue of *Tax Perspectives* will discuss the tax consequences of taking income out of Websiteco, either back to Canada or to an offshore holding company, and will review some possible treaty and non-treaty countries.

TAX PERSPECTIVES

*Tax Perspectives* is published quarterly by the Tax Specialist Group (TSG). The founding members of TSG are Bateman MacKay, Cadesky and Associates, and Moody Finningley Shikaze. The TSG Web site address is www.taxspecialistgroup.ca. Enquiries may be directed to any member firm.

BATEMAN MACKAY
4200 South Service Road, PO Box 5015, Burlington, Ontario L7R 3Y8
TEL 905-632-6400 (Burlington), 416-360-6400 (Toronto)
FAX 905-639-2285 WEB www.bateman-mackay.com

CADESKY AND ASSOCIATES
2225 Sheppard Avenue E, Suite 1001, Atria III, Toronto, Ontario M2J 5C2
TEL 416-498-9500 FAX 416-498-9501 WEB www.cadesky.com

MOODY FINNINGLEY SHIKAZE
Suite 460, 734 7th Avenue SW, Calgary, Alberta T2P 3P8
TEL 403-209-4200 FAX 403-209-4201 WEB www.taxandestateplanning.com



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